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PERSIAN GULF: IMPACT OF A MAJOR OIL PRICE DECLINE

Summary

The oil market remains vulnerable to an unraveling of prices despite the recent OPEC attempts to head off such a development. Increasing output from non-OPEC suppliers and attempts by some producers to maintain market shares through price discounts and barter deals will cause continued downward pressures on oil prices for at least the next two years, unless there is a strong resurgence in demand. This memorandum is not an oil market forecast. It speculates that if oil prices plummet to about $20 per barrel there would be a good chance that the Iran-Iraq war would escalate, instability would grow in the Arab Peninsula states, and US interests in the area would be harmed. 25X1

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Iraq would be the Gulf country most seriously affected by a major oil price decline. A drop in oil prices to $20 per barrel would cost Baghdad nearly $4 billion a year in revenues--30 percent of the loss would result from the lower value of Saudi Arabian and Kuwaiti oil sold on Iraq's behalf. Iraq would be unable to increase oil exports to offset a drop in prices until the war ends or the oil export pipeline through Saudi Arabia is completed, probably in the first half of 1986. The sharp austerity that would be required to offset large revenue losses would increase the risk of the overthrow of President Saddam Husayn. 25X1

This paper was prepared by the Persian Gulf Division, Office of Near Eastern and South Asian Analysis. Comments and queries are welcome and may be directed to the Chief, Persian Gulf Division, NESA, 25X1

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In contrast, Iran has more than enough excess productive capacity to offset the impact of $20 per barrel oil. Rather than risk imposing tough austerity measures, we believe Iran would ignore its OPEC production ceiling and would use aggressive pricing tactics to market as much oil as it needs to maintain food and military imports. Only if Iranian efforts to maintain essential imports failed and the regime came to believe its hold on power was threatened by economic problems, would Tehran consider ending the war with Iraq. [redacted] 25X1

If Baghdad faces revenue shortfalls and austerity-induced unhappiness with President Saddam Husayn while Iran maintains earnings, we would expect Iraq to intensify attacks against Iranian oil shipments and perhaps oil facilities. During the next few months additional Exocet-equipped Mirage F-1 aircraft will arrive in Iraq and will complete the order for 20 aircraft. Baghdad then will have the ability to attack tankers and Iranian economic targets almost daily. Although Baghdad has preferred low-risk conservative tactics, it probably would delay an escalation only briefly while making one more try at ending the war through diplomatic channels. [redacted] 25X1

If a desperate Iraq escalates the war in the Gulf, Iran would have to respond. Although constrained by its smaller and less effective Air Force, Iran would increase attacks on tankers carrying crude from ports on the Arabian Peninsula, particularly in the lower Gulf beyond the range of Saudi air patrols. If Baghdad attacks Khark Island oil facilities or succeeds in reducing Iranian oil exports, Tehran probably would launch commando, terrorist, or air attacks against the Iraqi-Turkish pipeline or Arab oil facilities. [redacted] 25X1

<u>Unpleasant Choices for Saudi Arabia and Kuwait</u>

Saudi Arabia and Kuwait might seek to reduce the possibility of Baghdad escalating the war by providing additional massive financial transfusions. Such aid, however, would magnify the problems posed by their own large oil revenue losses and make even more difficult the tough choices between further domestic spending cuts, foreign asset drawdowns, and oil production levels. An escalation of the Gulf war, however, would pose serious risks as well, particularly for Kuwait whose oil facilities are a likely target if Iran retaliates for Iraqi attacks. On balance we believe the Saudis and Kuwaitis would decide ultimately to make up some of the Iraqi revenue losses. Nonetheless, the likely delays in providing aid and the failure to offset Iraq's financial losses totally would mean that a serious risk of an escalation in the war would remain. [redacted] 25X1

We believe the Saudis are ill-prepared to deal with the economic reversals that would stem from a major oil price decline. Saudi Arabia has coped so far with declining oil earnings by putting development projects on hold, paying bills late, reducing foreign aid, and drawing down assets by $15 billion a year. Although the Saudis still have about $120 billion in useable official foreign assets, they do not want reserve drawdowns to accelerate because reserves are considered an endowment for future generations. [redacted] 25X6

[redacted] 25X6

[redacted] Moreover, Saudis have become accustomed to a wide range of government subsidies and improvements in living standards, and would not welcome belt-tightening, [redacted] 25X6 25X6

Sharply lower oil prices also could generate serious tension within the Saudi Government about its commitment to OPEC. The Saudi role in OPEC has benefitted the Kingdom in the past and has ensured a place of leadership within OPEC councils and in making international oil policy. Faced with painful spending cutbacks, however, some Saudi leaders are likely to argue that they need to look after their own interests first. These arguments could gain in acceptance if Saudi Oil Minister Yamani, who reportedly is trying to resign, is replaced by a member of the royal family. 25X1

A sharp fall in oil prices would cause Kuwait fewer financial problems than other oil producing countries. Kuwait's nearly $70 billion in foreign assets provides a more than adequate buffer for its small population. Moreover, extensive foreign equity investments in the West probably would rise in value as oil prices fall. Nonetheless, Kuwaitis would blame the government for any cuts in domestic spending resulting from lower oil revenues and increased aid to Iraq. Although Kuwait has the productive capacity to increase oil output to offset lower prices, such increased production would put additional downward pressures on oil prices. 25X1

Other Arab States

The other Arab Peninsula states that depend heavily on oil revenues also would need to cut spending. Their decisions on foreign asset drawdowns and oil production would be similar to those faced by Saudi Arabia and Kuwait. Each has special problems, however, that would be made worse by a sharp fall in oil prices.

- -- Existing strains within the UAE between "have" and "have-not" emirates would worsen.
- -- Oman would have to reconsider expensive military purchases, primarily from the United Kingdom.
- -- Qatar's Amir, determined to avoid a recurrence of the brief recession of 1983, would violate OPEC production quotas and would further delay paying foreign aid commitments to Iraq, Syria, Jordan, and the PLO.
- -- Bahrain's dependence on Saudi aid would increase and the ruling Khalifa family probably would face increased Iranian-sponsored dissidence among Bahrain's 70-percent Shia population. 25X1

Implications for the United States

Although lower oil prices would lead to a slowdown in US exports to the Persian Gulf market, we believe they would contribute to a more robust US and world economy. A major price decline, however, would have negative implications for US interests interests in the Gulf region. Governments friendly to the United States would have to deal with troubled economies and popular discontent. They would be less able to carry out their foreign aid commitments to pro-Western Third World countries. For its part, the USSR might gain increased leverage in Iraq and perhaps Kuwait by offering favorable terms on its military equipment. An escalation of the Iran-Iraq war would generate pressures for greater US military involvement in the area. While this might create some opportunities for closer cooperation with states in the region, it could lead to a confrontation between US and Iranian forces.

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